VI.

ARGUMENT.

1.

In Holding That Petitioner Realized Taxable Income From The Acquisition And Subsequent Sale Of Its Own Stock, And That The Prior Regulations Dealing With Transactions Of That Character Were Erroneous, The Decision Of The Circuit Court Of Appeals Is Directly In Conflict With Applicable Decisions Of This Court.

In *Helvering v. R. J. Reynolds Tobacco Co.* (1939), 306 U. S. 110, and *First Chrold Corporation v. Commissioner* (1939), 306 U. S. 117, this Court held that the respective corporations realized no taxable income from the sales of their own treasury stock in the years 1929 and 1933, respectively. There can be no question that this was the express holding of those decisions, for in the opening paragraph of its opinion in the *Reynolds* case, this Court stated, 306 U. S., l. c. 111:

> "The sole question for decision is whether gain accruing to a corporation consequent on the purchase and resale of its own shares constitutes gross income within the meaning of Section 22 (a) of the Revenue Act of 1928."

Similarly, the first sentence of the opinion in the *First Chrold* case, decided in accordance with the holding in the *Reynolds* case, says, 306 U. S., l. c. 118:

> "This case presents the same question as that involved in No. 328 [the *Reynolds* case], decided this day."

Thus, in the only decisions of this Court on this precise point, we have two express holdings that "gain accruing to a corporation consequent on the purchase and resale of its own shares" does **not** constitute "gross income within

the meaning of Section 22 (a)" of the Revenue Acts of 1928 and 1932. Yet the decision of the Circuit Court of Appeals finds that exactly the same types of transaction **do** give rise to taxable income within the meaning of Section 22 (a) of the Revenue Acts of 1934 and 1936. This holding cannot be reconciled with the decisions of this Court.

The applicable provisions of Section 22 (a) of the Revenue Acts of 1928, 1932, 1934 and 1936 are identical. Indeed, the definition of gross income in Section 22 (a) has remained substantially unchanged since its adoption as Section II-B of the Revenue Act of 1913. It reads, so far as material to this case, as follows:

> "Sec. 22. GROSS INCOME.
>
> "(a) **General Definition.**—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *"

For more than fourteen years prior to May 2, 1934, the Treasury Regulations interpreting that section with respect to the sale by a corporation of its own capital stock had read, so far as material, substantially as follows (Articles 542 and 563 of Regulations 45, through Articles 66 and 176 of Regulations 77):

> "**Sale by corporation of its capital stock.**— * * * or if the corporation purchases any of its stock and holds it as treasury stock, the sale of such stock will be considered a capital transaction and the proceeds of such sale will be treated as capital and will not con-

stitute income of the corporation. A corporation realizes no gain or loss from the purchase or sale of its own stock."

It has been conclusively established by numerous decisions of this Court that the broad sweep of the language of Section 22 (a) indicates the purpose of Congress to use the full measure of its taxing power under the Sixteenth Amendment.

Irwin v. Gavit (1925), 268 U. S. 161, 166;
Douglas v. Willcuts (1935), 296 U. S. 1, 9;
Helvering v. Clifford (1940), 309 U. S. 331, 334.

It is likewise well established that the act of Congress alone fixes the rights and liabilities of taxpayers, to which the Treasury Department can neither add nor detract by its administrative regulations. The Act itself, and not the interpretation, is the ultimate source of those rights and liabilities. Cf. *Koshland v. Helvering* (1936), 298 U. S. 441, l. c. 445 et seq.

Thus, if capital stock transactions of this character gave rise to income under the Sixteenth Amendment, this Court would have been compelled to have decided the *Reynolds Tobacco Co.* case and the *First Chrold Corporation* case the other way, despite the long-standing interpretation of Section 22 (a) to the contrary in the regulations prior to 1934. *Koshland v. Helvering,* supra. The necessary implication of those decisions, therefore, is that those transactions did **not** result in taxable income and that the prior regulations holding them to be capital transactions were valid and proper. In fact, the propriety of the earlier regulations was expressly upheld by this Court in the *Reynolds* case (306 U. S., l. c. 114).

This being the case, the holding of the Circuit Court of Appeals in the case at bar that similar transactions in 1935 and 1937 did result in taxable income and that the

prior regulations to the contrary were erroneous is directly in conflict with the decisions of this Court in the *Reynolds Tobacco Co.* and *First Chrold Corporation* cases, supra.

2.

In Holding That the Treasury Department Has the Power, Merely by Amending Its Regulations, to Change a Valid, Long Settled Construction of a Statute Which Has Been Given the Force of Law by Congress, the Decision of the Circuit Court of Appeals Directly Conflicts With Other Applicable Decisions of This Court.

This Court not only expressly held, in *Helvering v. R. J. Reynolds Tobacco Co.* (1939), 306 U. S. 110, that the prior regulations were a proper interpretation of Section 22 (a) but also that Congress, by the repeated re-enactment of Section 22 (a) without change in the light of that consistent interpretation over a long period of years, "must be taken to have approved the administrative construction **and thereby to have given it the force of law"** (306 U. S., l. c. 114). This rule of legislative adoption of valid, consistent and long standing administrative interpretations is supported by numerous decisions of this Court, of which two of the more recent are *Helvering v. Winmill* (1938), 305 U. S. 79, l. c. 83, and *Morgan v. Commissioner* (1940), 309 U. S. 78, l. c. 81.

It is equally well settled that where the meaning of a statute has been established by an administrative construction which has thus acquired the force and effect of law that meaning can be changed only by Congress itself, and not by an administrative agency charged merely with carrying out the intention of the legislative body. For example, in *Helvering v. Oregon Mutual Life Insurance Co.* (1940), 311 U. S. 267, where after thirteen years of consistent administrative regulation and practice the Treasury Department had, as in the case at bar, sought

to reverse its prior construction by amending its regulations, this Court held that the meaning of the Act could be changed only by Congress, saying, through Mr. Justice Black, 311 U. S., l. c. 272:

> "For it is our conclusion that by Sec. 203 (a) (2) of the 1932 and 1934 Acts, Congress has granted life insurance companies a deduction for disability reserves **which only Congress can take away.**"

Similarly, in *Helvering v. Janney* (1940), 311 U. S. 189, involving a change in the regulations governing the deductibility of capital losses of one spouse from the capital gains of the other in a joint return, Mr. Chief Justice Hughes, speaking for this Court, concludes, 311 U. S., l. c. 194:

> "We are of the opinion that under the provisions of the Act of 1934 as to joint returns of husband and wife, which embodied a policy set forth in substantially the same terms for many years, Congress intended [etc.] * * *. This, we think, was the meaning of the provision of the Revenue Act of 1934 when it was enacted, and **it was subject to change only by Congress, and not by the Department.**"

Likewise, in *Morrill v. Jones* (1883), 106 U. S. 466, this Court said:

> "The Secretary of the Treasury cannot by his regulations alter or amend the law. All he can do is to regulate the mode of proceeding to carry into effect what Congress has enacted. * * * In our opinion, the object of the Secretary could only be accomplished by an amendment of the law. That is not the office of a treasury regulation."

Therefore, since (as was expressly held by this Court in *Helvering v. R. J. Reynolds Tobacco Co.*, supra) the prior regulations dealing with the sale by a corporation

of its own stock were a proper interpretation of Section 22 (a) and as such had been given the force and effect of law by Congress, that interpretation could be changed only by Congress and not by the Department; and the holding of the Circuit Court of Appeals to the contrary in this case is directly in conflict with the decisions of this Court in *Helvering v. Oregon Mutual Life Insurance Company*, *Helvering v. Janney*, and *Morrill v. Jones*, supra.

3.

In Holding That the Acquisition and Subsequent Sale by a Corporation of Shares of Its Own Capital Stock Can Result in Taxable Income, the Circuit Court of Appeals Has Decided an Important and Fundamental Question of Federal Constitutional Law Which, If It Has Not Already Been Decided, as We Contend, by This Court, Should Now Be Decided by This Court.

The question of whether or not the sale of treasury stock by a corporation is essentially a capital transaction resulting only in the acquisition of capital and not income is one of extreme importance in the law of federal taxation. For if such transactions are purely capital in nature and the amended regulations as applied by the Commissioner are allowed to stand, the effect will be to permit the imposition of a direct tax on capital in violation of Article I of the Constitution of the United States and beyond the scope of the Sixteenth Amendment of the Constitution of the United States. To paraphrase slightly the language of this Court in *Koshland v. Helvering*, supra, 298 U. S. 441, l. c. 445:

> "The question here," therefore, "is not merely of" the adoption by Congress or by this Court of the changed "administrative construction, but whether it should be adopted if in effect it converts an income tax into a capital levy."

We contend that this question has been conclusively resolved by the decision of this Court in *Helvering v. R. J. Reynolds Tobacco Co.*, supra, 306 U. S. 110, for the reasons set forth under Point I, ante, and that therefore the decision of the Circuit Court of Appeals is in complete and direct conflict with that case and should be reversed. If, however, in view of certain qualifying language of the opinion in the *Reynolds* case, this Court should be of the opinion that it has not passed on this precise question it should do so now; for to deny certiorari in this case, and thus presumptively leave this question open, will necessarily result in the imposition of a tax which may ultimately be held to be an unconstitutional levy of a direct tax on capital as and when this question is finally decided by this Court. We therefore strongly urge the Court to take jurisdiction in this case if for no other reason than that of clearly settling this extremely important, fundamental question of federal constitutional law.

4.

In Holding That a Ruling or Requirement of a Branch of the Federal Government Having Regulatory Powers Over a Taxpayer With Regard to the Treatment by It of Its Securities Is Not Binding Upon the Bureau of Internal Revenue, the Circuit Court of Appeals Has Rendered a Decision in Conflict With Decisions of Other Circuit Courts of Appeals on This Question.

The capital stock of petitioner is listed on the New York Stock Exchange, and petitioner is and was during the years here involved registered with the Federal Securities and Exchange Commission. As a registrant it is, of course, subject to the rules and regulations of that body with respect to the treatment of its securities. Of primary importance therefore is the following ruling contained in S. E. C. Accounting Series, Release No. 6, issued May 10, 1938:

"Question has been raised with respect to the proper treatment of an item of $488,211.83 representing 'Excess of proceeds from sale of 12,200 reacquired shares of the company's capital stock over the cost thereof.' These shares represent part of 41,400 shares of the capital stock of the registrant, a manufacturing company, reacquired by it prior to the year 1934 'for the purpose of resale when market conditions improved.'

"Under the laws of most states there are certain legal restraints upon the issuance of new shares that do not apply to the sale of treasury shares. **However, from an accounting standpoint, there appears to be no significant difference in the final effect upon the company between (1) the reacquisition and resale of a company's own common stock and (2) the reacquisition and retirement of such stock, together with the subsequent issuance of stock of the same class.**

"It is recognized that when capital stock is reacquired and retired any surplus arising therefrom is capital and should be accounted for as such, and that the full proceeds of any subsequent issue should also be treated as capital. Transactions of this nature do not result in corporate profits or in earned surplus. **There would seem to be no logical reason why surplus arising from the reacquisition of the company's capital stock and its subsequent resale should not also be treated as capital.**

"In my opinion the $488,211.83 excess of proceeds from the sale of 12,200 reacquired shares of this registrant's capital stock over the cost thereof **should be treated as capital stock or capital surplus as the circumstances require.**" (Emphasis ours.)

Viewing the matter from a realistic point of view, controlling consideration should be given to the fact that petitioner, being a registered corporation, was and is required by the Securities and Exchange Commission, in conformance with the foregoing ruling, to treat any surplus arising from the sale of these reacquired shares of its

own stock as capital and not as "profits or earned surplus." And the rule is well settled that a ruling or requirement of one branch of the government having regulatory power over the taxpayer with regard to the treatment by it of its securities is binding upon another branch of the government, and particularly upon the Bureau of Internal Revenue.

Thus, in *Citizens' Nat. Bank of Orange v. Commissioner* (1935, C. C. A. 4), 74 F. (2d) 604, a bank which was ordered by the national bank examiner to write down certain of its bonds, solely for the reason that their market values had declined materially, was held entitled to deduct the full amount of the write-down despite the fact that at the close of the year none of the bonds were in default and there was no indication that any of the bonds would not be collected at maturity. The Court said, l. c. 605:

> "Here we have a case in which one branch of the government can compel the taxpayer to take an action with regard to its securities which, when taken, will not be recognized by another branch of the government. This is not fair to the taxpayer. There should be at least some semblance of co-ordination between the several branches of the government in dealing with a taxpayer. It is immaterial as to what reason the bank examiner gave for ordering the charge off. His determination that the bonds were worthless in part was sufficient. The bank was under the necessity of complying with the instructions given, and it seems only reasonable that the bank should be allowed, in its return for the purposes of taxation, a deduction, corresponding in amount to the charge off made under compulsion. Otherwise the bank would be compelled to keep two sets of books, one, as directed by the bank examiner, and the other for the purpose of making its tax return."

And in conclusion the Court said, l. c. 606:

> "It is also contended on behalf of the respondent that fluctuations in the market values do not justify

> deductions, and with this contention we agree, but here the deduction was not made by the bank because of market fluctuations, but because of the order of the bank examiner, and, as we stated above, it is immaterial what reason the bank examiner gave for his action. The bank was, in any event, obliged to follow the examiner's orders."

This doctrine is applied to taxpayer and tax collector alike, as evidenced by the decision of the Third Circuit in *United States v. Beckman* (1939, C. C. A. 3), 104 F. (2d) 260, l. c. 264, where the rule was successfully invoked by the Commissioner of Internal Revenue. This eminently just and equitable doctrine has, we submit, an even stronger application to the case at bar than to the cases above cited. For, in the *Citizens' Bank* case, the controversy revolved about the disallowance of a claimed deduction, the permissibility of which is, after all, purely a matter of legislative grace; whereas, in the instant case we are directly concerned with the constitutional limitation of the power of Congress to tax only income, in a case where the Commissioner is claiming as additional income something which that branch of the government having regulatory power and control over the financial operations of the taxpayer states unequivocally to be capital and which is required to be treated as such by the corporation. Yet the Circuit Court of Appeals in our case states (R. 62):

> "Nor can the ruling of one administrative department of the government concerning income accounting control that of another department made for an entirely different purpose under another act of Congress."

In so deciding, the Circuit Court of Appeals for the Eighth Circuit is in direct conflict with the foregoing decisions of the Circuit Courts of Appeal for the Third and Fourth Circuits.

5.

In Relying On Certain Decisions Of This Court Which Petitioner Believes To Be Inapplicable To This Case, The Circuit Court Of Appeals Has Added To The Confusion Surrounding The Important Question As To The Scope Of Power Of Administrative Bodies To Amend Their Interpretative Regulations, Which Question Should Be Clarified and Settled By This Court.

Recognition of the general confusion that now exists, not only in the legal profession but in the Courts as well, with respect to the power of the Treasury Department to amend its regulations under varying circumstances is to be found in the recent opinion of this Court in *Helvering v. Griffiths* (1943), ... U. S. ..., 63 Sup. Ct. 636, 87 L. Ed. Adv. Op. 597, l. c. 611-612, where attention is called in footnote 47, to the various and not entirely consistent terms in which the question has been discussed by this Court and where it is expressly noted that the question of the power to make prospective amendments had been left open in the *R. J. Reynolds Tobacco Co.* case, supra, 306 U. S. 311, 316-317. The question is one of the greatest importance, albeit of considerable difficulty, and is directly raised in this case and should now be settled by this Court, so that some of the uncertainty, to which this Court has itself pleaded guilty, as aforesaid, in the *Griffiths* case, supra, may be laid at rest.

Certainly, the decision of the Circuit Court of Appeals in this case has considerably added to the general confusion, for in its apparent reliance on the decisions in *Morrissey v. Commissioner* (1937), 296 U. S. 344; *Helvering v. Wilshire Oil Co.* (1939), 308 U. S. 90, and *Helvering v. Reynolds* (1941), 313 U. S. 428, the Court has indicated an almost complete misconception of the true holding of those cases.

The *Morrissey* case involved an amended regulation

which merely clarified the earlier regulations and brought the administrative interpretation into closer accord with judicial decisions, and not one which, as in our case, completely changed an earlier construction which had been expressly approved by the Courts and had further been given the effect of law by Congress. The *Wilshire* case involved a legislative regulation under Section 23 (l) of the 1928 Revenue Act (i. e., a regulation by which the Commissioner was expressly authorized to fill in the details of the Act) and not a mere interpretative regulation such as is involved in the case at bar. Furthermore, the very section of the law itself had been changed by the Revenue Act of 1926 under which no similar regulation had been promulgated. This Court expressly held that the disputed phrase had thereby been restored "to its original ambiguity." The *Reynolds* case likewise involved the construction of a section of the Act which had just been changed by Congress and where there had been no prior regulation under the two preceding revenue acts.

None of those facts exist in the case at bar and despite some general language of the Court in those cases the holdings in none of them are applicable to or controlling on this case. To permit the opinion of the Circuit Court of Appeals to go uncorrected will do much to add to the already highly confused state of the law on this all important and constantly recurring question.

6.

In Holding That Petitioner Was Dealing In Its Own Shares As It Might In The Shares Of Another Corporation, The Circuit Court Of Appeals Has Sanctioned A Distortion Of The Clear Language And Intent Of The Treasury Regulations Which Should Be Rectified By This Court.

The revised regulation reads as follows [Art. 22 (a)-16 of Regulations 86 and 94]:

"**Acquisition or disposition by a corporation of its own capital stock.**—Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the **real nature of the transaction**, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.

"But **if a corporation deals in its own shares as it might in the shares of another corporation**, the resulting gain or loss is to be computed in the same manner as though the corporations were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from **such** transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of the Internal Revenue Code." (Emphasis Added.)

Even if the validity of the revised regulations were to be conceded, it still would not make the transactions here involved taxable. We have emphasized those portions of the regulations which are material to the case at bar. They are first, that whether or not the sale of capital stock gives rise to taxable income "depends upon the real nature of the transaction," and second, that "if a corporation deals in its own shares as it might in the shares of another corporation" it is an income transaction.

The facts here disclose that the real nature of these transactions was purely capital. These shares were acquired by petitioner at the time of its incorporation pur-

suant to a preincorporation underwriting agreement (R. 19). They were acquired for the sole purpose of ultimate sale or other disposition to petitioner's employees as a means of fostering their loyalty by giving them a proprietary interest in the company (R. 19). The stock of no other corporation could have served that purpose, nor could the stock of any other corporation have been acquired in that manner. The result, for all practical purposes, would have been precisely the same had petitioner originally issued only 95,000 shares or, having acquired the 5,000 shares as it did, had retired them and then had later issued additional shares to its employees pursuant to these employees' stock purchase plan, in which case admittedly there would have been no taxable gain. What was actually done was precisely the same in substance. Only the formal mechanics of the actual transactions were different. In other words, as a practical matter, these shares were exactly the same as authorized but unissued stock.

If it was the intention of the Commissioner in drafting these regulations to tax **every** disposition by a corporation of its own stock other than upon original issue, then there would have been no need for the inclusion in the regulation of the language quoted above. Obviously, the Commissioner and the Treasury Department, in promulgating the revised regulation, contemplated that there **are** certain transactions by a corporation in its own stock, other than the original issuance thereof, which are **really** capital in their nature and which do **not** give rise to taxable gain or deductible loss. If any proof of this proposition be needed, it is found in the fact that the Commissioner has already sought to disallow deductions in cases similar to the one at bar on the theory that in the sale of treasury stock a particular corporation was **not** dealing in its own shares as it might in the shares of another corporation. See

D. N. & E. Walter and Co. v. Commissioner, 1942 B. T. A. Memo. (C. C. H.—B. T. A. Service, Decision 12,576-B).

Yet when the Court holds, as it does in the opinion below, that the manner and purpose of the acquisition and sale by petitioner of its shares are immaterial and beside the point, and that the only thing which is material is the fact that the corporation did purchase these shares and did subsequently sell them, then the effect of the Court's holding is to emasculate the express language of the regulation and to disregard entirely the intention and purpose of the inclusion of the quoted language in the revised regulation.

Coming specifically to that portion of the Circuit Court's opinion which deals with the question of whether or not petitioner was dealing in these shares of its own treasury stock as it might in the shares of another corporation, we call attention to the following language appearing on the last page of the opinion (R. 68):

> "The point is made that the purchase and sale of the shares in another corporation could not satisfy the essential purpose of the employee purchase plan. **This, of course, is true** but immaterial. The material fact is that the corporation bought and sold its own stock at a profit, dealing, in controlling aspects of the transaction, as it might have dealt with the stock of another corporation." (Emphasis ours.)

We submit that this is wholly inconsistent. The Circuit Court concedes that the acquisition and sale of stock of another corporation "could not satisfy the essential purpose of the employee purchase plan." But, the opinion states, this, while perfectly true, is immaterial. How, we submit, can this be immaterial, when this is the determining factor established by the regulation? If the language of the regulation is to have **any meaning at all,** then this factor is not only material, but **determinative** of the issue.

Nor, we submit, does the statement that "the material fact is that the corporation bought and sold its own stock at a profit" meet the issue at all. As a matter of pure logic, this merely begs the question, for the sole issue **is** whether or not this transaction resulted in a "profit" within the meaning of Section 22 (a); and under the literal terms of the revised regulation the transaction does **not** result in a "profit" if the corporation has **not** dealt with its stock as it might with the stock of another corporation. The regulation provides that a taxable profit results only if the corporation deals in its own shares as it might in the shares of another, and admittedly here the corporation could **not** have used the shares of another corporation to accomplish its conceded purpose of fostering the loyalty and proprietary interest of its employees in its business.

Furthermore, the corporation here was not, as the opinion states, "dealing, in controlling aspects of the transaction, as it might have dealt with the stock of another corporation." **Petitioner acquired this stock in a manner in which it could not have acquired the stock of any other corporation.** It acquired these shares pursuant to the original preincorporation underwriting agreement of the original incorporators. **It could not have acquired the stock of any other corporation in that manner.** We submit again, therefore, that **in no sense** was petitioner dealing in these shares as it might in the shares of another corporation. The controlling aspects are the **method of acquisition** and the **purpose** for which these shares were so acquired and sold. They were, we submit, the same as **authorized but unissued shares**, and this issuance to the employees of the company was, therefore, a purely capital transaction and should be so treated even under the literal words of the revised regulation itself.

Unless it was the intention of the Court of Appeals to completely disregard the intention and purpose of the language of the revised regulation, we must assume that

the Court, on this phase of the case, simply overlooked the fact that **petitioner here neither purchased any of its own shares on the open market nor ever sold any of its own shares on the open market.** The corporation could have done what it did with the stock of only one corporation and that was the stock of Edison Brothers Stores, Inc.; namely, its own shares. Therefore, if the Circuit Court meant to hold, as it apparently does on the last page of its opinion, that the controlling aspect of the transactions involved is the mere fact that there has been a purchase and a later sale by the corporation of its own shares at a different price, then that Court has entirely overlooked the controlling language of the revised regulation as well as the purpose and intention of that language, and in so doing has fallen into serious error on a matter of federal law which should be corrected by this Court.

CONCLUSION.

For all of the reasons set forth in the petition and supported by the argument and authorities cited in this brief, we respectfully submit that this case is one calling for the exercise by this Court of its supervisory powers in order that the various conflicts and errors herein pointed out may be corrected, and to that end we strongly urge that the petition for a writ of certiorari be granted.

Respectfully submitted,

J. SYDNEY SALKEY,
SAM ELSON,
PETER H. HUSCH,
Attorneys for Petitioner.

Of Counsel:

SALKEY & JONES,
506 Olive Street,
St. Louis, Missouri.

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